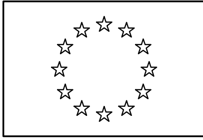

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JANUARY 2006 UPDATE OF THE CONVERGENCE PROGRAMME OF POLAND (2005-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

Poland submitted its convergence programme on 19 January 2006, more than one month and a half after the date specified in the code of conduct. The delay was caused by a change of government in November 2005 following parliamentary elections and a change of the minister of finance in early January 2006. The programme covers the period 2005 to 2008. The document was adopted by the government on 18 January 2006. It incorporates the government 2006 budget, as amended in December 2005 by the new government. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.[2]

On 5 July 2004 the Council decided that Poland was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2007. In its opinion of 17 February 2005 on the previous update of the convergence programme, covering the period 2004-2007, the Council invited Poland to "(i) strengthen the fiscal adjustment beyond 2005 and lower the deficit target for 2007; (ii) to ensure a full implementation of the structural measures contained in the *Hausner plan* and make further efforts to introduce alternative measures if implementation risks were to materialize".

Polish real GDP growth averaged 4.5% per year between 1994 and 2004 more than two percentage points above the EU25 average of 2.4%. After a period of strong economic expansion, real GDP growth fell to 1.0% in 2001, reflecting both domestic and external cyclical factors. It has since rebounded reaching 5.3% in 2004. Per capita income in purchasing power standards reached 46.5% of the EU25 average in 2004. HICP inflation has remained high, at 7.0% on average, over the last ten years, but it dropped significantly in 2005, to ca. 2%. The labour market situation remains Poland's major problem. As a consequence of economic restructuring, the unemployment rate increased from 13.2% in 1994 to 18.8% in 2004, while total employment rate decreased by more than 7 percentage points over the same period. Structural problems in the labour market, in particular low geographical mobility of workers and skills mismatches, remain an important impediment to economic growth. For the last ten years, the general

[1] This technical analysis, which is based on information available up to 24 February 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 1 March 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Michal Narozny (Michal.Narozny@cec.eu.int) or Aleksander Rutkowski (Aleksander.Rutkowski@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

[2] The programme provides all compulsory and most of the optional data prescribed by the new code of conduct. The data on employment and labour productivity measured per hours worked have not been provided. General government expenditure by function for 2008 is missing. Differences between cash and accruals, net accumulation of financial assets are also missing. Total revenues and expenditures in Table 7 (long-term sustainability) are missing.

government balance has been negative in Poland. It fluctuated between -1.4% and -4.8%[3] of GDP until 2003, when it started to improve, reaching -3.8% of GDP in 2004.

Following an increase in real GDP of 3.3% in 2005, the programme's macroeconomic scenario expects economic growth to gradually strengthen to 4.3% in 2006 up to 5.0% in 2008, which is broadly in line with the Commission services' autumn 2005 forecasts for the years 2005-2007. For the year 2008, the programme's growth projection is above the Commission services' estimate of potential growth. The growth assumptions underlying the programme can thus be considered as plausible, tilted to favourable in the outer year.

Poland pursued a successful policy of disinflation in the recent years with only two short periods of temporary inflation hikes (in 2000 and 2004). The harmonised index of consumer prices (HICP) decreased from 15% in 1997 to ca. 2% in 2005. The exchange rate has fluctuated widely over the past years, along a broad appreciation trend apparent since March 2004, interrupted temporarily in spring 2005. The appreciation resumed in May 2005 and, despite increased volatility, lasted for the rest of the year. The progressive decrease of the spread vis-à-vis the euro area on long-term government bond yields observed since August 2004 was interrupted by uncertainty surrounding the September 2005 elections and the new government's economic agenda. Polish monetary policy continues to be based on direct inflation targeting combined with a free float of the zloty. Since 2004, the inflation target has been defined as a continuous year-on-year CPI inflation of 2.5 percent. Poland intends to pursue the current monetary policy system until a possible ERM II entry, the date of which has not been announced yet.

As regards budgetary implementation in 2005, the general government deficit is estimated at 2.9% of GDP in the January 2006 update of the convergence programme (against 3.6% of GDP in the Commission services' autumn 2005 forecast and a deficit target of 3.9% of GDP set in the previous update of the convergence programme). However, comparison with previous convergence programmes is not straightforward because of significant data revisions due to methodological changes. The better-than-expected outcome was mainly determined by the budgetary performance of the central government, in particular the state budget, which recorded (on a cash basis) higher-than-planned direct tax revenues and an under-execution of expenditures, reducing the deficit by about 0.7 percentage points compared to the budget plan for 2005.

The current update of the convergence programme aims at a gradual reduction of the general government deficit to meet the convergence criteria by the end of the legislature, hence implicitly by the end of 2009. The deficit target for 2009 is not quantified. The deficit target for 2007 is unchanged at 2.2% of GDP, with the open pension funds included in the general government sector. Excluding the open pension funds from the government sector, the deficit target was revised upwards, compared to the previous update, from 3.9% of GDP to 4.1% of GDP because the estimated cost of the pension reform increased from 1.7% to 1.9% of GDP. The primary balance (open pension funds in the general government sector) is expected to improve from –0.3% of GDP in 2005 to 0.6% in 2008. This slow adjustment is driven by favourable revenue developments in 2006 and some expenditure cuts in 2007 and 2008. Compared with the previous update, the current update sets a more ambitious deficit target in 2006, but afterwards the adjustment effort is lower and expenditure reforms are postponed until 2007 and 2008.

[3] EDP definition, all pension funds classified within the general government sector, revised data.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance is planned to improve on average by merely a ¼ percent of GDP per year, evenly spread over the programme period. The update identifies a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact of around -1% of GDP, which it expects to achieve after 2010, well beyond the programme horizon.

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around -1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO reflects the debt ratio and average potential output growth in the long term.

The balance of risks to the budgetary projections is negative. On the one hand the record of overachievement of the budgetary targets set in the previous programmes makes the budgetary projections cautious. On the other hand, assumptions about tax elasticities are rather optimistic, in particular in 2006. Furthermore, the growth assumptions in the outer year of the programme period (i.e. 2008) seem favourable. In the current political climate, miners have been granted special pension rights, inducing other social groups to claim a special treatment, undermining the pension reform. There is also a political source of risk attached to the budgetary projections. Already in the past it was difficult to implement a large part of the so called *Hausner plan* of public finance restructuring because the government lacked support of the parliament. The current political situation (a minority government) is not favourable to introducing measures aiming at the reduction of the general government deficit and achieving long-term public finance sustainability. The nominal anchor of PLN 30bn for the state budget, introduced in the convergence programme, does not appear sufficient to eliminate the causes of high deficits in Poland, i.e. too fast growth of public expenditure.

The programme does not follow the deficit reduction path specified by the Council in its recommendation under Article 104(7). Even at face value, the fiscal stance in the update seems inconsistent with a correction of the excessive deficit by the deadline set by the Council. The conclusion is reinforced taking into account the balance of risks. The deficit targets for 2005 and 2006 are lower than in the previous update and meet the nominal deficit targets set in the Council recommendation of 5 July 2004, thanks to better than planned execution of the 2005 budget with carry-over effects to 2006. A comparison of targets is, however, complicated by changes in national accounts methodology and data revisions. For the critical year 2007, the programme foresees a deficit reduction to 2.2% of GDP. However, when excluding the second-pillar funded pension schemes from the general government sector in line with the Eurostat decision of 2 March 2004, the planned deficit in 2007 is at 4.1% of GDP, which is not close to the 3% threshold. Substantial additional adjustment effort would be needed to correct the excessive deficit by the set deadline.

Between 2005 and 2008, government debt is expected to increase by 3¼ percentage point of GDP and reach 45½% of GDP in 2008, well below the 60% of GDP reference value but, if the open pension funds are excluded from the general government sector, the debt ratio will reach 52.6%. A significant debt increasing stock-flow adjustment is expected to offset the effect of a primary surplus and a favourable snowball effect (i.e. the negative contribution of the implicit interest is more than offset by sustained high nominal GDP growth).

With regard to the sustainability of public finances, Poland appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of debt is currently under the 60% reference value and should remain so under the assumption that

savings related to the full implementation of the 1999 pension reform will materialise. Measures recently adopted by the government to exclude particular employment groups from the reformed pension scheme could weaken the reform's long-term outcome, particularly if further exemptions from the pension schemes were granted. The realization of contingent liabilities as well as the currently high structural deficit may increase the debt/GDP ratio faster than planned over the medium term. Implementing rigorously the planned consolidation of public finances over the medium-term would reduce risks to long-term sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. However, the planned adjustment is not sufficient to correct promptly the excessive deficit.

The National Reform Programme of Poland, submitted on 5 January 2006 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: budgetary consolidation in view of high deficits, upgrading the underdeveloped transport and environment protection infrastructure, reinforcing public sector R&D and innovation, promoting a more robust approach to raising employment rates through reducing charges imposed on labour for the low paid. The budgetary implications of the actions outlined in the National Reform Programme are not presented in the budgetary projections of the convergence programme. Among the public finance measures included in the National Reform Programme, convergence programme mentions the deficit anchor and the multi-annual budgetary planning.

In view of the above assessment, the Commission notes that the convergence programme does not envisage the correction of the excessive deficit in 2007, as required by the Council recommendation of 5 July 2004. Accordingly, the Commission intends to recommend further steps under the excessive deficit procedure as required by the Stability and Growth Pact. In the meantime, Poland should:

(i) strengthen the adjustment in 2006 in particular, by allocating any higher-than-budgeted revenues or lower-than-budgeted expenditure to deficit reduction;

(ii) improve the long-term sustainability of the reformed pension system;

(iii) enhance the institutional framework of public finances by introducing a medium-term expenditure rule.

Comparison of key macroeconomic and budgetary projections[1]

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Jan 2006**	**5.3**	**3.3**	**4.3**	**4.6**	**5.0**
	COM Nov 2005	5.3	3.4	4.3	4.5	n.a.
	CP Dec 2004	*5.7*	*5.0*	*4.8*	*5.6*	*n.a.*
HICP inflation (%)	**CP Jan 2006**	**3.6**	**2.2**	**1.5**	**2.2**	**2.5**
	COM Nov 2005	3.6	2.2	2.3	2.5	n.a.
	CP Dec 2004	*3.5*	*3*	*2.7*	*2.5*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2006[2]**	**0.4**	**0.1**	**0.3**	**0.3**	**0.6**
	COM Nov 2005[5]	0.4	0.2	0.4	0.6	n.a.
	CP Dec 2004[2]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Jan 2006**	**-3.8**	**-2.9**	**-2.6**	**-2.2**	**-1.9**
	COM Nov 2005	-3.9	-3.6	-3.6	-3.4	n.a.
	CP Dec 2004	*-5.4*	*-3.9*	*-3.2*	*-2.2*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2006**	**-1.2**	**-0.3**	**-0.2**	**0.3**	**0.6**
	COM Nov 2005	-1.2	-1.0	-1.1	-1.0	n.a.
	CP Dec 2004	*-2.6*	*-1.3*	*-0.5*	*0.4*	*n.a.*
Cyclically-adjusted and Structural balance[3] (% of GDP)	**CP Jan 2006**	**-4.1**	**-2.9**	**-2.7**	**-2.3**	**-2.1**
	COM Nov 2005[4]	-4.1	-3.7	-3.7	-3.6	n.a.
	CP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2006**	**41.9**	**42.5**	**45.0**	**45.3**	**45.4**
	COM Nov 2005	43.6	46.3	47.0	47.3	n.a.
	CP Dec 2004	*45.9*	*47.6*	*48.0*	*47.3*	*n.a.*

Notes:

[1]The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance according to the updated programme would be -5.6% of GDP in 2004, -4.7% in 2005, -4.6% in 2006, -4.1% in 2007 and -3.7% in 2008, while government gross debt would be 45.9% of GDP in 2004, 47.9% in 2005, 51.2% in 2006, 52.1% in 2007 and 52.6% in 2008.

[2]Commission services calculations on the basis of the information in the programme

[3]Cyclically-adjusted balance and structural balance are the same since one-off and other temporary measures taken from the programme are insignificant (0.04% of GDP in 2005, deficit-reducing)

[4]There are no one-off and other temporary measures in the Commission services' forecast

[5]Based on estimated potential growth of 3.3%, 3.6%, 4.2% and 4.5% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Poland submitted its convergence programme on 19 January 2006, more than one month and a half after the date specified in the code of conduct[4]. The delay was caused by the formation of a new government in November 2005, following parliamentary elections and the replacement of the minister of finance in early January 2006. The programme covers the period 2005 to 2008. The document was adopted by the government on 18 January 2006. It incorporates the 2006 budget, as amended in December 2006 by the new government. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. The programme provides all compulsory and most optional data prescribed by the new code of conduct[5] (for details see Annexe 2).

2. ECONOMIC OUTLOOK

Polish real GDP growth averaged 4.5% per year between 1994 and 2004, i.e. more than two percentage points above the EU25 average. After a period of strong economic expansion, real GDP growth fell to 1.0% in 2001, reflecting both domestic and external cyclical factors. It has since rebounded reaching 5.3% in 2004. Per capita income in purchasing power standards reached 46.5% of the EU25 average in 2004. HICP inflation has remained high, at 7.0% on average, over the last ten years, but dropped significantly in 2005, below 2%. Labour productivity growth has been very strong compared to the EU average over the last decade. As a consequence of economic restructuring, the unemployment rate increased from 13.2% in 1994 to 18.8% in 2004, while total employment decreased by more than 7 percentage points over the same period. Also, the employment rates of young and elderly people (at 21.7% and 26.2% in 2004, respectively) are far below the EU 25 averages (36.8% and 41% in 2004, respectively). Long-term unemployment has doubled since 1997 to 10.2% of active population and the share of long-term unemployment in percent of unemployment has increased from 46.4% in 1997 to 54.0% in 2004. Structural problems in the labour market, in particular low geographical mobility of workers and skills mismatches, are behind the difficult labour market situation and remain an important impediment to economic growth.

The macroeconomic scenario presented in the programme estimates real GDP to grow by 3.3% in 2005. Real GDP growth is forecast to steadily increase thereafter, reaching 5.0% in 2008. Cyclical conditions implied by the programme (as measured by the output gap recalculated by Commission services with the commonly agreed methodology) are estimated to be favourable and gradually improving over the programme horizon.[6]

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4 The English version was submitted on 31 January 2006.

5 The data on employment in hours worked and labour productivity measured as GDP per hours worked have not been provided. There are no data for general government expenditure by function for 2008. Differences between cash and accruals, net accumulation of financial assets are also missing. Total revenues and expenditures in Table 7 (long-term sustainability) are missing.

6 The calculation of potential growth (and therefore of the output gap) needs to be interpreted with caution, in particular for countries going through a rapid catching-up process.

The growth outlook and its composition are broadly in line with the Commission services' autumn 2005 forecasts for the years 2005-2007. However, for the year 2008, the programme's growth projection is above the Commission services' current estimate of potential growth. The growth assumptions underlying the programme can thus be considered as plausible, tilted to favourable in the outer year.

The key external assumptions underlying the programme's macroeconomic scenario, including the exchange rate between USD and EUR, the development of oil prices, GDP growth in the EU-25 and growth of the main foreign markets, are broadly in line with the Commission services' forecast.

The updated programme predicts positive labour market developments against the backdrop of a robust growth performance. Employment is expected to increase during the entire programme period, at an average rate of 1.1%. The projected average labour content of GDP growth is above historical values, similar to the projections in the Commission services' autumn 2005 forecasts. Favourable cyclical conditions, and also a projected fall in the participation rate, are expected to contribute to the decline in the rate of unemployment which is projected to fall by 3.1 percentage points by the end of the programme period (from 17.8% in 2005 to 14.7% in 2008). The fall in the unemployment rate foreseen by the programme is broadly in line with the Commission services' autumn 2005 forecasts.

The convergence programme forecasts a decrease in HICP inflation from 2.2% in 2005 to 1.5% in 2006, followed by an increase to 2.5% in 2008. Relatively low inflation is projected against a sharp fall in unemployment indicating an improvement in structural labour market conditions. While broadly in line with this picture, the Commission services' forecasts project somewhat higher inflation, reflecting also a more severe impact of oil prices than assumed in the update.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		**2006**		**2007**		**2008**
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Real GDP (% change)	3.4	3.3	4.3	4.3	4.5	4.6	5.0
Contributions:							
- Final domestic demand	3.2	2.8	4.1	4.4	4.6	5.3	5.2
- Change in inventories	-0.7	-1.1	0.4	0.0	0.3	0.0	0.0
- External balance on g&s	0.8	1.5	-0.3	-0.1	-0.4	-0.7	-0.3
Output gap[1]	0.2	0.1	0.4	0.3	0.6	0.3	0.6
Employment (% change)	1.0	1.6	1.2	1.0	1.2	1.1	1.0
Unemployment rate (%)	17.8	17.8	16.8	16.7	15.5	15.7	14.7
Labour productivity growth (%)	2.3	1.7	3.0	3.3	3.2	3.5	4.0
HICP inflation (%)	2.2	2.2	2.3	1.5	2.5	2.2	2.5
GDP deflator (% change)	2.3	1.3	2.2	1.1	2.5	1.7	2.1
Compensation of employees (% change)	4.1	6.1	4.4	4.6	4.4	5.1	5.8
External balance (% of GDP)	-3.2	-1.0	-3.6	-1.5	-3.9	-1.5	-0.8

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

The estimate of potential output growth consistent with the programme's macroeconomic scenario (as recalculated by the Commission services on the basis of the information provided in the programme according to the agreed methodology) is broadly in line with

the estimates presented in the Commission services' autumn 2005 forecasts. Potential output growth is estimated to increase from 3.6% in 2005 to 4.5% in 2007. The largest contribution is expected to come from total factor productivity, followed by strong capital accumulation.

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	3.6	3.6	4.0	4.1	4.3	4.5	4.8
Contributions:							
- Labour	-0.2	-0.1	0.1	0.3	0.3	0.5	0.5
- Capital accumulation	1.4	1.4	1.5	1.5	1.7	1.8	2.0
- TFP	2.3	2.2	2.3	2.2	2.3	2.2	2.2

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

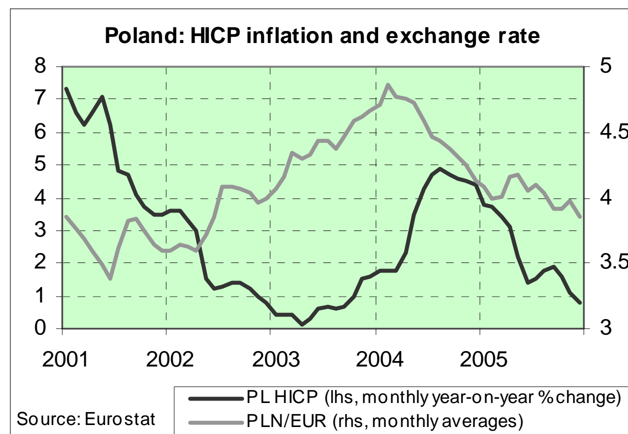
The new update projects the external deficit to decrease to 1.0% of GDP in 2005 from 3.8% in 2004, reflecting an improvement in all its components (the trade balance, balances of primary incomes and transfers). A continuous improvement in the balances of primary incomes and transfers is projected to more than offset a widening trade deficit, leading to a further decline in the external deficit to 0.8% of GDP in 2008. Significant data revisions since the time the Commission services' forecast was prepared and updated information on developments in the trade balance in 2005 explain the difference between the Commission services' forecast and the programme projections for the external balance.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Polish monetary policy continues to be based on direct inflation targeting combined with a free float of the zloty. Since 2004, the inflation target has been defined as a continuous year-on-year CPI inflation of 2.5 percent with a ±1% tolerance margin. The National Bank of Poland does not rule out foreign exchange interventions, should they be necessary for the inflation target implementation, though it currently does not use this instrument. According to the monetary policy guidelines for 2006, Poland intends to pursue the current monetary policy system until a possible ERM II entry. The convergence programme does not announce a target date for euro introduction, but specifies that Poland aims at meeting the Maastricht reference values by the end of the legislative term of the current Parliament (i.e. 2009).

In recent years, Poland has recorded relatively low, although volatile, inflation. HICP inflation increased in 2004 to an average of 3.6 percent compared with 0.7 percent in 2003, partly as a result of some one-off EU accession-related factors, including a faster increase of food prices. With these effects fading out, year-on-year inflation rates have been falling since the fourth quarter of 2004 and reached a low of 0.8 percent in December 2005 putting the 2005 average annual inflation at 2.2 percent. Besides base effects, the zloty appreciation also contributed to the progressive decrease of inflation.

The exchange rate has fluctuated widely over the past years, with a broad appreciation trend apparent since March 2004. This trend was temporarily interrupted in spring 2005, when a generalized withdrawal of investors from European emerging markets weakened the PLN/EUR exchange rate by around 10 percent. The appreciation resumed in May 2005 and, despite increased volatility, lasted for the rest of the year. Higher exchange rate volatility mainly reflected swings in investors` sentiment affected by political uncertainty and by monetary and fiscal policy.



The easing of inflationary pressures since the end of 2004 allowed the central bank to decrease policy rates in four steps by a cumulative 200 basis points in 2005 and by another 25 basis points on 31 January 2006. This brought the reference rate to its present level of 4.25 percent, 200 basis points above the euro area level. Money market rates moved broadly in line with central bank decisions; the three-month money market interest rate progressively decreased from around 6.6 percent at the beginning of 2005 to below 4.5 percent in January 2006.

The progressive decrease of the spread vis-à-vis the euro area on long-term government bond yields observed since August 2004 was interrupted by uncertainty surrounding the September 2005 elections and the new government's economic agenda. The spread on 10-year benchmark bonds widened by some 80 basis points and exceeded 200 basis points in November 2005. Markets recovered towards the end of 2005, reflecting reassuring signals by the government and robust underlying economic fundamentals. Yield spreads narrowed, but at 160 basis points they still remain around 30 basis points higher than in September.

4. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous convergence programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005

The current update of the convergence programme broadly confirms the adjustment path for the general government balance presented in the previous updates (see Table 3). It foresees a reduction in the deficit from 2.9% of GDP (with the second-pillar funded pension scheme classified within the general government sector) in 2005 to 1.9% of GDP in 2008.

The comparison with previous updates of the programme is not straightforward because of methodological changes[7] and data revisions introduced by the Polish central statistical office (GUS). The actual state budget deficit (on a cash basis) in 2005 is estimated at 82% of the deficit planned in the 2005 budget bill. On the expenditure side, the result reflects incomplete execution of public investment plans. On the revenue side, higher than planned tax receipts, are largely attributable to corporate income tax and personal income tax reforms adopted in 2003 (in force since 2004). Reflecting the results estimated for 2005, the targets for 2006 have been improved in the current update compared to the previous one despite lower projected real GDP growth. However, the target for 2007 has been left unchanged.

Table 3: Evolution of budgetary targets in successive programmes[1]

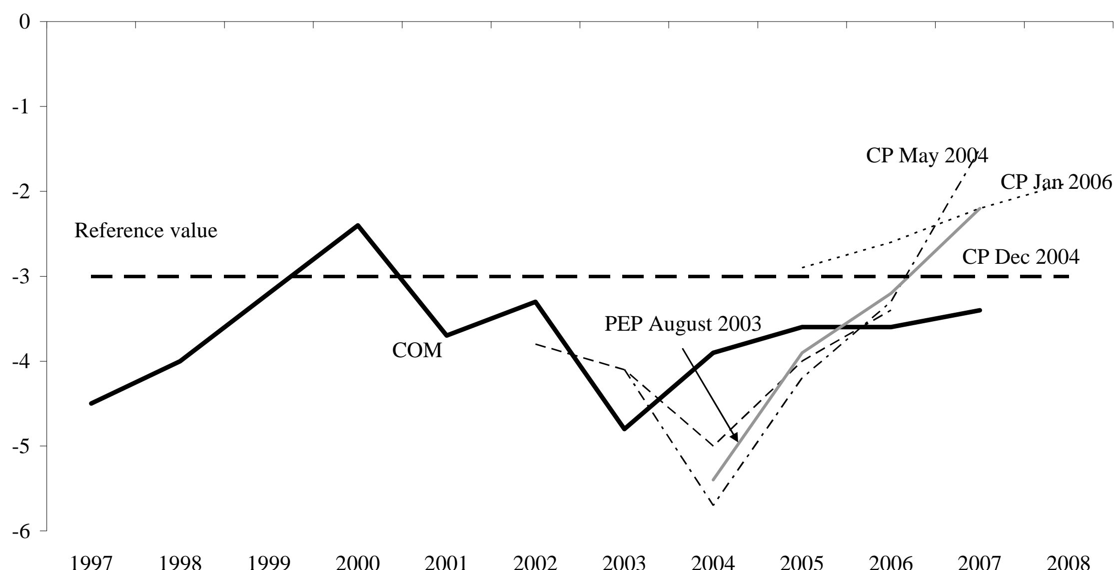
		2004	**2005**	**2006**	**2007**	**2008**
General government balance (% of GDP)	**CP Jan 2006**	**–3.8**	**–2.9**	**–2.6**	**–2.2**	**–1.9**
	CP Dec 2004	–5.4	–3.9	–3.2	–2.2	n.a.
	CP May 2004	*–5.7*	*–4.2*	*–3.3*	*–1.5*	*n.a.*
	COM Nov 2005	–3.9	–3.6	–3.6	–3.4	n.a.
General government expenditure (% of GDP)	**CP Jan 2006**	**43.0**	**44.9**	**44.7**	**43.7**	**42.4**
	CP Dec 2004	48.6	48.4	48.0	46.2	n.a.
	CP May 2004	*56.3*	*54.6*	*53.3*	*50.6*	*n.a.*
	COM Nov 2005	44.8	45.0	45.0	44.6	n.a.
General government revenues (% of GDP)	**CP Jan 2006**	**39.2**	**42.0**	**42.1**	**41.5**	**40.5**
	CP Dec 2004	43.2	44.5	44.8	44.0	n.a.
	CP May 2004	*50.6*	*50.4*	*50.0*	*49.1*	*n.a.*
	COM Nov 2005	40.9	41.4	41.4	41.2	n.a.
Real GDP (% change)	**CP Jan 2006**	**5.3**	**3.3**	**4.3**	**4.6**	**5.0**
	CP Dec 2004	5.7	5.0	4.8	5.6	n.a.
	CP May 2004	*5.0*	*5.0*	*5.6*	*5.6*	*n.a.*
	COM Nov 2005	5.3	3.4	4.3	4.5	n.a.

Note:
[1]The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. See Table 4 for the quantification of this effect on the general government balance in the most recent update.

Source:
Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

[7] A modified method of converting cash data into accrual data.

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes.
** Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007.*

Box 1: The excessive deficit procedure for Poland

On 5 July 2004, the Council decided that Poland had an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007, with the following annual targets for the general government deficit: 5.7% of GDP in 2004, 4.2% of GDP in 2005, 3.3% in 2006 and 1.5% of GDP in 2007. In particular, Poland was recommended to implement with vigour the measures envisaged in the convergence programme, in particular those contained in the so-called *Hausner plan*. This plan was proposed in 2003 and it constituted the most comprehensive and specific attempt at expenditure reform so far, aimed at reducing public expenditure on social protection, public administration and state aid. The Polish authorities were recommended to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target. In addition, the Council invited the Polish authorities to allocate possible extra revenues to decrease the general government deficit.

On 22 December 2004, the Commission stated, in its communication to the Council, that the Polish government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target in response to the Council recommendation. Accordingly, the Commission concluded that no further steps were necessary at that point under the excessive deficit procedure.

On 17 February 2005, the Council issued its opinion on the updated convergence programme of Poland for 2004–2007. The Council advised: firstly, to strengthen the fiscal adjustment beyond 2005 and lower the deficit target for 2007; secondly, to ensure a full implementation of the structural measures contained in the *Hausner plan* and to make further efforts to introduce alternative measures if implementation risks materialised.

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The budgetary strategy outlined in the updated programme is to gradually reduce the general government deficit so as to meet the convergence criteria by the end of the current legislative term of the parliament i.e. 2009. However, the target for 2009 is not explicitly revealed and there is a gap between the declared goal and the budgetary targets because the target for 2008 is far from the reference value (by 0.7 percentage point of GDP, with the second-pillar funded pension schemes excluded from the general government sector).

The updated programme keeps the target for the deficit in 2007 unchanged at 2.2% of GDP, with the second-pillar funded pension schemes included in the general government sector. However, the projected pension reform costs in that year increased and to1.9% of GDP and, if the pension schemes are excluded from the government sector in accordance with the Eurostat decision of 2 March 2004, the deficit target increases to 4.1% of GDP (compared to 3.9% of GDP in the previous update). The new deficit target for 2008 is set at 1.9% of GDP, which is equivalent to 3.7% of GDP, once the Eurostat decision taken account of.

The update introduces a "deficit anchor", which aims at maintaining the nominal deficit of the state budget at PLN 30bn (3.1% of GDP in 2005) in the period 2006–2009.

After the strong budgetary consolidation recorded in 2005 (0.9 percent of GDP), progress is projected to be more gradual in the subsequent years (0.3-0.4 percentage point annually). Concerning the primary balance, almost no consolidation is planned for 2006 (improvement by 0.1 percentage point) with some stronger improvement in 2007 (0.5 percentage point).

Although the current update foresees lower deficit levels in 2005 and 2006, the previous convergence programme was more ambitious in terms of adjustment pace. The December 2004 update envisaged to reduce the deficit (open pension funds outside the general government sector) by 3.2 percentage points over the programme period 2004-2007(from 5.4 to 2.2% of GDP), whereas in the present update the adjustment over the same period is reduced to 1.6 percentage points (from 3.8% of GDP to 2.2% of GDP in 2007). Hence, the considerably better-than-expected results in 2004 and 2005 are not carried over in the new programme. The slower pace of planned adjustments can only partly be explained by a downward revision of the growth forecast.

The implementation of the Eurostat decision of 2 March 2004 on the classification of second-pillar funded pension schemes affects significantly the general government deficit ratio. The impact is expected to be largest in 2006: 2% of GDP. In the following years it is supposed to decline to 1.9% and 1.8% of GDP in 2007 and 2008, respectively. Consequently, the general government deficit is planned to decrease from 4.7% of GDP in 2005 to 3.7% in 2008.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	Change: 2008-2005
Revenues	**39.2**	**42.0**	**42.1**	**41.5**	**40.5**	**–1.5**
of which:						
- Taxes & social contributions	33.1	34.6	35.8	36.0	35.4	0.8
- Other (residual)	6.1	7.4	6.3	5.5	5.1	–2.3
Expenditure	**43.0**	**44.9**	**44.7**	**43.7**	**42.4**	**–2.5**
of which:						
- Primary expenditure	40.4	42.3	42.3	41.2	39.9	–2.4
of which:						
Collective consumption	8.2	8.0	7.7	7.6	7.3	–0.7
Transfers & subsidies	26.2	27.1	27.0	26.2	25.2	–1.9
Gross fixed capital formation	3.4	3.9	4.0	4.0	4.0	0.1
Other (residual)	2.6	3.3	3.6	3.4	3.4	0.1
- Interest expenditure	2.6	2.6	2.4	2.5	2.5	–0.1
General government balance (GGB)	**–3.8**	**–2.9**	**–2.6**	**–2.2**	**–1.9**	**1.0**
- excluding second-pillar pension scheme[1]	*–5.6*	*–4.7*	*–4.6*	*–4.1*	*–3.7*	*1.0*
Primary balance	**–1.2**	**–0.3**	**–0.2**	**0.3**	**0.6**	**0.9**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-off & other temporary measures	**–3.8**	**–2.9**	**–2.6**	**–2.2**	**–1.9**	**1.0**

Note:
[1]This shows the general government balance as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.

Source:
Convergence programme update; Commission services' calculations

4.2.2. The composition of the budgetary adjustment in the programme

The current update foresees a reduction in the deficit from 2.9% of GDP (with the second-pillar funded pension scheme classified within the general government sector) in 2005 to 2.2% of GDP in 2007 and 1.9% of GDP in 2008. Consolidation is achieved via a planned reduction of the expenditure ratio that exceeds the projected decrease of the revenue ratio. Revenues from taxes and social contributions are expected to rise moderately relative to GDP, offset by a stronger decline in other revenues. Expenditure reductions are postponed until 2007 and 2008 (Table 4). The ratio of public investment is estimated to have increased in 2005 and is expected to remain at a level of 4% of GDP in the subsequent years of the programme period. This is above the EU average and corresponds to the average ratio in the recently acceded member states. The lower expenditure ratio is expected to be achieved in 2007 and 2008 mainly through reductions in social transfers and subsidies relative to GDP and a gradual reduction in the collective consumption ratio. In 2006, consistent with the draft budget (see Box 2), some social transfers[8] are projected to grow slightly (by 0.2% of GDP) and decrease only in the following years. Social expenditure is high in Poland. According to data based on the Classification of the Functions of Government (COFOG) provided in the update, spending on social protection increased by 1 percentage point to 18.5% of GDP in 2005 and is above the average for both the 'old' and the 'new' Member States.

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[8] Such as subsidies for farmers, measures against malnutrition, paid maternity leaves, family benefits for newborn children.

Box 2: The budget for 2006

The previous Polish government adopted the draft 2006 budget on 27 September and presented a state budget deficit at PLN 32.5bn to Parliament on 30 September.

The new government has not modified the growth or inflation assumptions for 2006. However, it proposed a new fiscal rule: a 4-year nominal anchor for the state budget deficit at PLN 30bn (i.e. ca. 3.1% of GDP in 2005).

On 29 November, the new government approved an amendment to the draft 2006 budget leading to a state budget deficit for 2006 which is slightly higher (over PLN 30.5bn) than the proposed anchor. At the same time, the new government decided to increase social expenditure (family benefits for children, longer paid maternity leaves and subsidising children nutrition). Planned social expenditure was increased by PLN 800mn (i.e. 0.1% of GDP in 2005). The Parliament adopted additional social expenditure and subsidies by PLN 1.3bn (i.e. 0.14% of GDP in 2005). As at that stage of the procedure the deficit could not be increased, the government had to propose a second amendment by which extra expenditure was balanced with cuts in some other expenses, higher profits of the central bank and more optimistic VAT revenue projections. As a result of all the amendments, planned social expenditure was increased by more than 0.2 percentage point compared to the draft proposed by the previous government. The 2006 budget was approved by the upper chamber on 1 February.

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update plans to achieve the MTO (a general government deficit of 1% of GDP) beyond the current time horizon of the convergence programme. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance would improve from -2.9% of GDP in 2005 to -2.1% in 2008 (including the second-pillar funded pension schemes in the government sector). If the pension funds are excluded from the general government sector, the structural balance would improve from -4.7% in 2005 to -3.9% in 2008, i.e. 2.9 percentage points above the MTO. It should be noted that output gap calculations presented in the programme differ substantially from Commission services' calculations based on the

information provided in the programme according to the commonly agreed methodology.[9]

The structural balance is planned to improve on average by merely a ¼ percent of GDP per year. The planned improvement is evenly spread over the programme period.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008	Change: 2008-2005
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-3.9	-3.8	-3.6	-2.9	-3.6	-2.6	-3.4	-2.2	-1.9	1.0
One-offs[2]	0.0	0.0	0.0	0.04	0.0	0.0	0.0	0.0	0.0	-
Output gap[3]	0.4	0.4	0.2	0.1	0.4	0.3	0.6	0.3	0.6	-
CAB[4]	-4.1	-4.1	-3.7	-2.9	-3.8	-2.7	-3.7	-2.3	-2.1	0.8
change in CAB	0.1	0.1	0.4	1.2	-0.1	0.2	0.1	0.4	0.2	-
CAPB[4]	-1.4	-1.4	-1.1	-0.3	-1.3	-0.3	-1.3	0.2	0.4	0.7
Structural balance[5]	-4.1	-4.1	-3.7	-2.9	-3.8	-2.7	-3.7	-2.3	-2.1	0.8
change in struct. bal.	0.1	0.1	0.4	1.2	-0.1	0.2	0.1	0.4	0.2	-
Struct. prim. bal.[6]	-1.4	-1.4	-1.1	-0.3	-1.3	-0.3	-1.3	0.2	0.4	0.7

Notes:
[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures
[3]In percent of potential GDP. See Table 1 above.
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

4.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO reflects the debt ratio and average potential output growth in the long term.

4.3.2. Risks attached to the budgetary targets

The balance of risks to the budgetary projections is negative. Although the record of overachievement of the budgetary targets set in the previous programmes may make the

[9] National calculations are done using the Hodrick-Prescott filter, which gives a negative output gap that closes in 2008.

budgetary projections look cautious, several factors weigh on the planned adjustment. Assumptions about the tax elasticity are rather optimistic, in particular in 2006, as no tax reforms have been implemented yet. As reported in Table 6, the apparent elasticity of tax revenues to GDP in the programme for 2006 is significantly above both the OECD ex-ante elasticity and the observed elasticity in the Commission services' autumn 2005 forecast. In 2007, when some tax reforms aiming at broadening of the tax base[10] are planned to be implemented, the difference is smaller but still significant. Furthermore, the growth assumptions in the outer year (2008) seem favourable.

As a result of ongoing political developments, the budgetary cost of the pension reform may become smaller in a short run (lower participation in the funded second pillar pension scheme), but it would imply a heavier burden on the old pension system with all the inherent risks. The new government has withdrawn the previous government's call on the Constitutional Court to declare the law on special miners' pensions incompatible with the Constitution (because of inequality of treatment). According to estimates of the Polish Ministry of Labour, these special pensions may entail cumulative expenditure of up to PLN 70bn (7.5% of 2005 GDP) by 2020. Other social groups have already made demands for special pension schemes, undermining the pension reform. This risk is recognised in the current update.

The Commission services' autumn 2005 forecasts project a worse budgetary outcome for the whole period than the targets set in the January 2006 convergence programme update. The difference is mainly due to more cautious tax projections and the information of the better-than-expected execution of the 2005 budget was not available at the cut-off date of the forecast.

A broader political risk weighs on the budgetary projections. Because of lack of support in parliament the implementation of the so called *Hausner plan* providing the blueprint for the restructuring of public finances, already difficult in the past, is likely to prove impossible in the situation emerging from the autumn 2005 elections.

Table 6: Assessment of tax projections

	2006		**2007**		**2008**	**p.m.: OECD[1]**
	COM	**CP**	**COM[2]**	**CP**	**CP**	
Total taxes						
Change in tax-to-GDP ratio	0.0	1.3	-0.7	0.2	-0.6	/
Difference	1.3		0.9		/	/
of which[3]: - elasticity component	1.4		1.3		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity to GDP	1.0	1.7	0.7	1.1	0.8	0.91

Notes:
[1]OECD ex-ante elasticity relative to GDP
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

[10] Only a general description is given in the convergence programme. The Commission forecast was based on no-policy-change assumption.

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

The budgetary strategy in the programme is not in line with the deficit reduction path specified by the Council in its recommendation under Article 104(7). Even taken at face value, the fiscal stance in the update seems inconsistent with a correction of the excessive deficit by the deadline set by the Council. The conclusion is reinforced taking into account the balance of risks.

The deficit targets for 2005 and 2006 are lower than in the previous update (2.9% and 2.6% vs. 3.9% and 3.2%, respectively) and meet the nominal deficit targets set in the Council recommendation of 5 July 2004 (4.2% and 3.3% of GDP, respectively), thanks to better than planned execution of the 2005 budget with carry-over effects to 2006. A comparison of targets is, however, complicated by changes in national accounts methodology and data revisions. For the critical year 2007, the programme foresees a deficit reduction to 2.2% of GDP. However, when excluding the second-pillar funded pension schemes from the general government sector in line with the Eurostat decision of 2 March 2004, the planned deficit in 2007 is at 4.1% of GDP, which is not close to the 3% threshold, and hence excluding abrogation. The current update does not comply with the Council Opinion of 17 February 2005, which suggested reducing the target for the general government deficit for 2007 below 2.2% of GDP (second-pillar funded pension schemes included in the sector) and speeding up the adjustment. Substantial additional adjustment effort would be needed to correct the excessive deficit by the deadline set by the Council.

The speed of fiscal adjustment (in structural terms) envisaged in the programme, regardless of the risks to the budgetary projections as described in section 4.3.2, is slow, also taking into account an overall assessment of economic conditions: projected GDP growth is strong, cyclical conditions as measured by the output gap are favourable, and unemployment is expected to decline significantly. Although the analysis of tax elasticities (see Table 7) does not reinforce the notion of good times in 2007, it does so in 2006. According to the new code of conduct, Member States should increase their fiscal adjustment effort in good times, and the average of effort 0.2 percentage points per year in the programme cannot be considered sufficient.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	ex-ante[1]	COM[2] (observed)	ex-ante[1]
Total taxes Change in tax-to-GDP ratio	0.0	-0.2	-0.7	-0.2
Difference	0.2		-0.4	
of which[3]: - elasticity component	0.2		-0.4	
- composition component	-0.1		-0.1	
p.m.: Elasticity to GDP	1.0	0.9	0.7	0.9

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The strategy for the reduction of the general government deficit outlined in the programme is broadly consistent with the broad economic policy guidelines in the area of public finances. However, the planned adjustment is not sufficient to ensure a prompt correction of the excessive deficit (see Annex 3).

4.4. Sensitivity analysis

A sensitivity analysis is presented in the programme in the form of two alternative scenarios – an optimistic and a pessimistic one – with respect to the baseline scenario. The alternative scenarios are not fully-fledged and based on shocks in foreign demand and exchange rates fluctuations in the recently acceded Member States. The analysis is not entirely clear about the underlying assumptions on how revenues and expenditure react to the shocks. In a pessimistic scenario (real GDP growth levels-off at 3.5% in 2006–2008), the general government balance improves only slightly from –2.9 to –2.8% of GDP. In an optimistic scenario (real GDP growth accelerating from 4.3% in 2006 to 5.0% in 2008) the balance improves by 0.5 percentage point annually on average (from –2.4% of GDP in 2006 to –1.3% of GDP in 2008).

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter[11] and (iii) no policy response (notably, the expenditure level is as in the central scenario[12]), reveal that, by 2008, the cyclically-adjusted balance is ½ percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth,

[11] In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[12] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

additional measures of around ½ percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[13]

5. General government gross debt

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

According to the update, the debt ratio is estimated to fall moderately by 1.1 percentage point to 42.5% of GDP in 2005. The target debt ratio was set at 47.6% of GDP in the previous programme. The autumn 2005 Commission services' forecast projected a rise by 2.7 percentage points to 46.3% of GDP in 2005, due to a higher primary (and overall) deficit and a large positive stock-flow adjustment.

Over the rest of the programme period, the debt ratio is projected to hover around 45% of GDP. After an increase by 2.5 percentage points in 2006, it would rise only slightly thereafter to reach 45.4% of GDP in 2008.

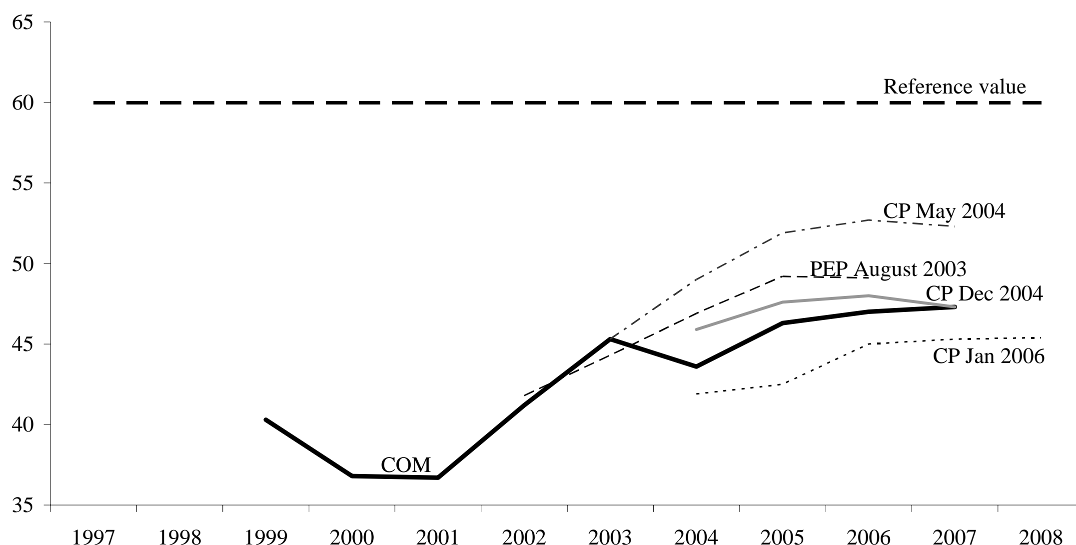
The developments in the debt ratio are mainly influenced by the stock-flow adjustment, which is expected to have a large debt-increasing effect throughout the programme period. The programme does not elaborate on the reasons for this. In the outer years of the programme, the impact of the stock-flow adjustment on the rise in debt will be largely offset by a small primary surplus and a debt-decreasing snow-ball effect.

Debt targets set in the new update are clearly below the targets presented in the previous update as a result of valuation effects, data revisions and better budgetary results in 2005.

The classification of the second-pillar funded pension schemes (open pension funds) outside the general government sector, which is due in spring 2007, will result in an increase in the debt ratio by 6.4 percentage points on average between 2005 and 2008 (5.4 p.p. in 2005, 6.2 p.p. in 2006, 6.8 p.p. in 2007 and 7.2 p.p. in 2008). These amounts correspond to the assets of the second-pillar pension scheme invested in government bonds. While they are currently consolidated, they will be considered as debt at the moment the pension schemes will be moved from the government to the corporate sector. Therefore, once the pension schemes are reclassified, the debt target for the end of the programme horizon will be revised, *ceteris paribus*, to 52½% of GDP.

[13] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

Figure 2: Debt projections in successive convergence programmes (% of GDP)*



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes.
** Excluding the impact of the 2004 Eurostat decision on the classification of funded pension schemes, which needs to be implemented by spring 2007.*

Table 8: Debt dynamics

	average 2000-2004	2005		2006		2007		2008
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio	**41.7**	**46.3**	**42.5**	**47.0**	**45.0**	**47.3**	**45.3**	**45.4**
Change in debt ratio (1 = 2+3+4)	1.7	2.7	-1.1	0.7	2.5	0.3	0.3	0.1
Contributions:								
- **Primary balance** (2)	**1.0**	**1.0**	**0.3**	**1.1**	**0.2**	**1.0**	**-0.3**	**-0.6**
- **"Snow-ball" effect** (3)	**0.9**	**0.3**	**-1.0**	**-0.3**	**0.2**	**-0.7**	**-0.2**	**-0.5**
- Interest expenditure	2.9	2.6	2.6	2.5	2.4	2.4	2.5	2.5
- Real GDP growth	-1.1	-1.4	-1.3	-1.8	-1.7	-2.0	-1.9	-2.1
- Inflation (GDP deflator)	-0.9	-0.9	-2.3	-1.0	-0.4	-1.1	-0.8	-0.9
- **Stock-flow adjustment** (4)	**-0.3**	**1.3**	**-0.4**	**0.0**	**2.1**	**0.0**	**0.8**	**1.2**
- Cash/accruals	0.2							
- Accumulation of financial assets	-0.1							
of which: Privatisation proceeds	-0.4	0.0	-0.3	0.0	-0.4	0.0	-0.3	-0.2
- Valuation effects & residual adj.	-0.3		-0.3		0.3		-0.2	-0.2
p.m.: Debt ratio excl. second-pillar pension scheme[2]			47.9		51.2		52.1	52.6

Notes:

[1]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

[2]This shows general government gross debt as it will be after the Eurostat decision of 2 March 2004 on the classification of funded pension schemes has been implemented, which needs to be done by the time of the spring 2007 notification.

Source:
Convergence programme update (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

5.2. Assessment

The programme's projections for government debt are consistently below the Commission services' autumn 2005 forecasts, which projected the debt ratio to increase to 47.3% of GDP in 2007. This mainly reflects a lower debt ratio in 2005 than had been estimated by the Commission services' forecast. Moreover, for years the 2006 and 2007, the Commission services project an increase in the debt ratio by 1 percentage point against an increase by 2.8 percentage points in the update. The difference between the two forecasts stems mainly from consistently more optimistic projections of the primary balance in the convergence programme, particularly in 2007, and the different estimates of the stock-flow adjustment, especially in 2006.

Significant movements in the exchange rate which can result from an unstable political situation may reverse the small debt decreasing impact from the valuation effects that have been observed in 2000–2004. In addition, the update mentions contingent liabilities which may become effective if the parliament endorses some re-privatisation bills (returning property to its former owners). The total amount due stemming from these liabilities has been estimated at ca. 3% of GDP in 2005. The current update also foresees an increasing indebtedness of the special fund which finances the construction and renovation of roads.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The updated programme states that the government intends to extend the budgeting horizon to three years to increase the transparency and stability of fiscal policy. In addition, an introduction of "task-oriented budgets" is planned. This system is expected to reduce unnecessary expenditure and allocate the saved funds to the most effective projects. "Task-oriented budgets" should, at least partly and gradually, eliminate the currently dominating indicative budgeting (increasing expenditure between years by some indicator) which hampers making more efficient composition of expenditure. If implemented consistently, this change may contribute both to an improvement of the fiscal situation and to strengthening of structural reforms (e.g. in the labour market) through concentration of resources where they are really needed.

A four-year nominal "anchor" for the state budget deficit introduced by the new government and mentioned in the update is compatible with a multi-annual approach to budgeting. However, it has a number of weaknesses. It does not address the cause of the excessive deficits i.e. too high social expenditure, so it may result in a growing tax burden. It covers the state budget only and thus allows for shifting deficits to other parts of the general government sector. It is also not very ambitious. At the current level of the nominal anchor and with the forecast real GDP growth, it may not be sufficient to realise the declared goal of complying with the convergence criteria by 2009. Consequently, the anchor should be made more ambitious or it should be complemented by some expenditure rule (see Box 3).

On the revenue side, the update announces the government's intention to introduce a tax reform with a view to simplifying the tax system and reducing direct taxation. The programme projects that, as a result, the tax revenue-to-GDP ratio will decline after 2007. The update assumes that a higher absorption of EU funds will have a favourable impact referring to the European Council decision to raise the maximum share of EU

funds in a project to 85%. The update mentions also that a new Ministry of Regional Development has been created but policy measures of that ministry to improve the absorption rate are, so far, missing.

Furthermore, an improvement in public expenditure management should result from the following measures: (i) an elimination of overlaps in competencies leading to some downsizing of the administration and (ii) a stronger monitoring of expenditure through an internal audit. It is difficult to predict the impact of these measures as it will depend on their specific design, in particular, the introduction of new auditing institutions (to supplement the existing ones, e.g. the Supreme Chamber of Control, NIK)[14].

The institutional innovations concerning public finances (in particular, the multi-annual nominal "deficit anchor" and "task-oriented budgeting") appear to be generally consistent with the broad economic policy guidelines. However, the programme is poorly integrated with the National Reform Programme (NRP). The reform measures envisaged in the NRP (e.g. improved targeting of unemployment and disability benefits, changes in the farmers' social insurance (KRUS), and healthcare system reforms) are not mentioned in the update, and consequently, there is no assessment of their budgetary effects. As recognised in the update of the convergence programme, the ratio of social expenditure to GDP is high in Poland. However, no measures are envisaged in this area. The programme foresees only a moderate reduction in social transfers in 2007 and 2008 after an increase in 2005 and 2006. Despite the intention to significantly upgrade the underdeveloped infrastructure, announced in the NRP, general government investment expenditure remains unchanged at 4% of GDP in 2005–2008. The convergence programme refers explicitly to the risks of the long-term sustainability of public finance posed by allowing some groups of people working in difficult conditions (such as miners) to have their pensions financed by the state budget (see Section 7).

Box 4: Improving expenditure management: does Poland need an expenditure rule?

National expenditure rules can supplement the EU fiscal rules in several ways. Firstly, they address the principal source of the fiscal imprudence: political and institutional bias to raise expenditure in good times. Secondly, they support automatic stabilisers by helping prevent tax increases in economic downturns. Thirdly, they can contribute to improving the quality of public spending because, under a binding ceiling, less needed expenditure will have to be reduced to give room for more desirable expenditure (European Commission, 2005). Simulations for the EU economies suggest that fiscal consolidations are likely to be expansionary (i.e. stimulating GDP growth) already in a short run, if they are based on expenditure cuts rather than tax hikes (European Commission, 2003).

Poland has national fiscal rules concerning the state budget and the debt. The Polish Constitution, Art. 216(5), stipulates that the public debt (national definition) shall not exceed 60% of GDP. In addition, Art. 220 of the Constitution states that only the government is allowed to increase the level of the deficit, while the parliament may only modify the composition of revenue and expenditure. The Polish Public Finance Act (Art. 45) sets additional safety thresholds and adjustment requirements: if the public debt (plus the expected calls on state guarantees) is higher than 50% of GDP, but below 55%, the draft budget for the following year must not propose a higher deficit-to-expenditure ratio than in the current year. This constraint applies also to local governments. If the debt is between 55% and 60% of GDP, the draft budget for the following

[14] Supreme supervisory body is empowered by the Polish Constitution (Art. 202–207) to exercise wide-ranging audit of general government revenue and expenditure as well as enterprises employed under public procurement.

year must not propose a deficit which would increase the level of the debt. If the debt exceeds 60% of GDP despite the previous safeguards, any government borrowing is forbidden in the subsequent year, which means that the state budget should be balanced or even in surplus.

The sanctions associated with breaching the second and, especially, the third threshold provided for by the Polish Constitution and the Polish Public Finance Act are so harsh that they might be unfeasible in reality. This undermines the credibility of these fiscal rules. It also needs to be stressed that the Polish definition of the public debt is wider, i.e. more restrictive than the excessive-deficit-procedure (EDP) definition (Polarczyk, 2004). Therefore, according to the former, the debt ratio relevant for the application of national rules is significantly higher compared to that relevant for the EDP (by more than 5% of GDP). The incorporation of the EDP definition of general government debt into the Polish law is now discussed. It will make the critical thresholds more remote and allow for a continuation of high general government deficits. Therefore, an additional fiscal rule may be necessary to eliminate and avoid persistent high deficits.

Two fiscal rules, which were proposed in Poland, have attracted some attention. According to the *Belka rule* proposed in 2001, real growth of public expenditure should not exceed 1% per year. The rule refers to the state budget only and has never been adopted. A *four-year nominal deficit "anchor"* is mentioned in the update of the convergence programme. The anchor also covers only the state budget.

Effective fiscal rules should respond to a few criteria (European Commission, 2005). Firstly, the rule should be binding i.e. *incorporated into law*. Preferably this ought to be embedded in the Constitution. Secondly, the rule should *encompass the general government sector* to prevent shifting deficits to agencies and funds or local municipalities outside the state budget. Thirdly, the rule should *cover a sufficiently long period* to reduce the opportunities for 'creative accounting' by shifting annual expenditure and revenue. Fourthly, the rule should be designed to *target the source of imbalances*, namely high expenditure. Unlike revenue, government expenditure depends more on discretionary decisions of policy-makers. Expenditure rules may help to eliminate excessive deficits, without increasing the tax burden. In Poland, the fiscal regime is 'expenditure-led', which entails adjusting tax revenues to the planned levels of government expenditures (Green et al., 2001) and the high share of social expenditure is the main source of persistent deficits. As regards social expenditure, it is particularly important to ensure that not too high new expenditure obligations are imposed on the budget because it creates entitlements which are then legally-binding for the government for many years.

In addition, it has been suggested that expenditure rules should be specified as a *real rate of growth rather than as an absolute value or a share of GDP* to make it anti-cyclical. With expenditure growth set at a reasonable level, expenditure can increase faster than GDP during slowdowns and it is restrained below the rate of GDP growth during good times. The cap on the real rate of expenditure growth directly targets the desired adjustment of the expenditure-to-GDP ratio. Alternatively, if this adjustment path is hard to control due to high uncertainty in the inflation forecast or very different deflators across different expenditure components, nominal growth rates can be used. 'Escape clauses' (allowing to change ceilings ex-post in case of very high inflation) could be foreseen provided they are reserved for extreme cases only (European Commission, 2003).

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7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of the Poland's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[15] remains unchanged at the 2005 level throughout the programme period.

In the case of Poland, the Commission's analysis is based on government expenditure on pensions and education, which are the only age-related expenditure projections included in the update.[16] On the basis of the programme information, both expenditure items are foreseen to fall by 5.5% of GDP between 2008 and 2050, to which the projected fall in pension expenditure contributes most, by 4.3% of GDP (see Table A2 in the Annex).

The gross debt-to-GDP ratio is currently below 60% of GDP and is projected to remain below the reference value throughout the projection period up to 2050 (see Table A4 in the Annex).[17]

According to both sustainability indicators (the S1 and S2 indicators), taking into account the available long-term projections on pension and education expenditures, there is no sustainability gap for Poland. The projected fall in pension and education expenditures in fact indicates negative sustainability gaps, measured by both indicators, in both scenarios. Taking into account the medium-term budgetary plans in the programme scenario, the sustainability gap (S2) narrows down to 2.5% of GDP, confirming that if implemented the planned consolidation contributes to lower risks to the long-term sustainability.

This sustainability gap translates into a required primary balance (RPB) of about 2 ½% of GDP, higher than the adjusted structural primary deficit of about 1 ½% of GDP in the last year of the programme period[18]. The currently large structural government deficit,

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[15] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out. Moreover, the revenue side is also corrected for the impact of the switch to second-pillar pensions (see Box 1); it therefore differs from the structural balance published in the medium-term analysis.

[16] The pension projection covers all three public pension systems (the general one, for farmers and supply system for uniformed services). Apart from education, other age-related items covered in the EPC common projections (health-care, long-term care and unemployment benefits) are not provided in the programme. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

[17] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen forecast.

[18] The structural primary balance includes, in the long-term analysis, the revenue-decreasing impact of the switch to the second-pillar pension schemes (see box 1). It therefore differs from the government deficit in the programme which includes revenue from second-pillar pension schemes and from the structural primary balance used in the assessment of the programme in the medium term. Given that there is no sustainability gap for Poland in the period up to 2050, there is no cost of a five-year delay in adjusting the budgetary position according to the S1 and S2 (see the sensitivity test in Table A3 in the Annex).

beyond the Treaty threshold in 2005, prevents a rapid reduction of debt. The need to consolidate the current budgetary position is therefore a priority.

Table 9: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB					
	2005 Scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value (of which)	**-1.9**	**-1.9**	**-2.4**	**-2.5**	**-2.5**	**-2.4**
initial budgetary position	2.2	2.7		1.6	2.1	
debt requirement in 2050	-0.1	:		-0.1	:	
future changes in budgetary position	-4.0	-4.6		-4.0	-4.6	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[19]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

The underlying assumptions used when making the long-term projections on pensions and education are those commonly agreed and used by the Economic Policy Committee in the current common projections exercise and can thus be considered as plausible. No information is, however, available in the update on other age-related expenditures than pensions and education, which underestimates the budgetary impact of ageing populations.

The large decrease in the expenditure levels is a consequence of the new pension scheme implemented in 1999. It is worth mentioning that this is the result of a rise in retirement age but also of the expected fall in replacement rates, due to application of the defined contribution system as well as due to projected increases in life expectancy. The pension disbursement from the funded pillar may not fully offset the expected fall in the replacement rates. As recognised in the Poland's National Strategy Report on Adequate and Sustainable Pensions, such a projected deterioration of the relationship between the old-age pension, and wages may raise concerns regarding the financial adequacy of pensions, which could eventually lead to a higher than currently projected pension expenditures over the long term.[20]

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[19] The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

[20] "Poland: National Strategy Report on Adequate and Sustainable Pensions", Ministry of Social policy, Poland, August 2005. Available at: http://europa.eu.int/comm/employment_social/social_protection/docs/2005/pl_en.pdf , 3 February 2006.

The projections in the current update do not consider the recent changes in the pension system, endorsed by the government, which reverse the pension reform measures for the groups of people working in difficult conditions, e.g. miners, implying a higher than expected increase in projected pension expenditure in the future. The same bill prolongs the right to early retirement of any person employed in difficult conditions until the end of 2007. The update acknowledges that the bill may encourage other organised professional groups to demand special pension schemes financed by the state budget which would worsen the long-run sustainability of public finance in Poland.

Moreover, the implementation of the *Hausner plan*, aimed at reducing public expenditure on social protection, including parametric changes to the pension system, public administration and state aids has not been as successful as previously planned.[21] Among the measures in *the Hausner plan,* related to curbing pension expenditures, a new, less generous indexation rule was adopted, while the plan to equalize the retirement age of men and women, new rules for sickness benefits and family allowances, as well as changes in the farmers' special social security system (KRUS), have been abandoned.

The programme update notes that some contingent liabilities may become effective if the parliament endorses some re-privatisation bills. The total amount due stemming from these liabilities has been estimated at a non-negligible amount of around 3% of GDP. Given the currently weak budgetary position, the risk of debt assumptions further stresses the importance of implementing the planned budgetary consolidation over the medium term.

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[21] The initial expected budgetary impact of the plan amounted to 4.7% of GDP between 2004 and 2007 with some measures to still take effect beyond that period. According to a report endorsed by the Polish government (Raport z realizacji „Programu uporzadkowania i ograniczenia wydatków publicznych", 2005), around 60% of the planned consolidation has been implemented by May 2005. The budgetary impact of the measures was estimated at 2.8% of GDP over 2004 – 2007. Further implementation of the planned measures is uncertain and depends on the newly elected government.

Annex 1: Summary tables from the convergence programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	886.5	5.3	3.3	4.3	4.6	5.0
2. Nominal GDP	B1*g	922.2	9.5	4.6	5.4	6.4	7.2
Components of real GDP							
3. Private consumption expenditure	P.3	564.7	4.0	2.3	3.7	3.5	3.6
4. Government consumption expenditure	P.3	168.8	3.9	2.0	2.0	3.5	3.2
5. Gross fixed capital formation	P.51	163.5	6.3	5.0	8.7	12.5	11.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	17.5	2.0	0.9	0.9	0.8	0.8
7. Exports of goods and services	P.6	320.2	14.0	5.8	6.1	6.1	6.5
8. Imports of goods and services	P.7	348.4	15.2	1.4	6.2	7.8	6.9
Contributions to real GDP growth							
9. Final domestic demand			4.4	2.8	4.4	5.3	5.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		1.6	-1.1	0.0	0.0	0.0
11. External balance of goods and services	B.11		-0.7	1.5	-0.1	-0.7	-0.3

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			4.0	1.3	1.1	1.7	2.1
2. Private consumption deflator			3.1	1.7	1.1	1.8	2.1
3. HICP[22]			3.6	2.2	1.5	2.2	2.5
4. Public consumption deflator			3.0	1.6	1.1	1.8	2.1
5. Investment deflator			1.4	0.6	2.4	2.4	2.4
6. Export price deflator (goods and services)			8.3	-3.3	1.0	1.0	1.0
7. Import price deflator (goods and services)			4.8	-2.8	1.6	1.3	1.0

22 Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[23]		13778	-0.3	1.6	1.0	1.1	1.0
2. Employment, hours worked[24]							
3. Unemployment rate (%)[25]		18.8	18.8	17.8	16.7	15.7	14.7
4. Labour productivity, persons [26]		64.3	5.6	1.7	3.3	3.5	4.0
5. Labour productivity, hours worked[27]							
6. Compensation of employees	D.1	344140	4.0	6.1	4.6	5.1	5.8

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	3.8	1.0	1.5	1.5	0.8
of which: - Balance on goods and services		1.9	0.1	0.8	1.5	1.6
- Balance of primary incomes and transfers		2.3	1.4	1.2	0.5	-0.2
- Capital account		-0.4	-0.5	-0.5	-0.5	-0.7
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	0.0	1.9	1.1	0.7	1.1
3. Net lending/borrowing of general government	B.9	-3.8	-2.9	-2.6	-2.2	-1.9
4. Statistical discrepancy						

[23] Occupied population, domestic concept national accounts definition.
[24] National accounts definition.
[25] Harmonised definition, Eurostat; levels.
[26] Real GDP per person employed.
[27] Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-34.9	-3.8	-2.9	-2.6	-2.2	-1.9
2. Central government	S.1311	-49.1	-5.3	-4.4	-4.6	-4.1	-4.0
3. State government	S.1312	–	–	–	–	–	–
4. Local government	S.1313	-0.2	0.0	-0.2	0.0	-0.2	-0.1
5. Social security funds	S.1314	14.4	1.5	1.7	2.0	2.1	2.2
General government (S13)							
6. Total revenue	TR	361.8	39.2	42.0	42.1	41.5	40.5
7. Total expenditure	TE[28]	396.7	43.0	44.9	44.7	43.7	42.4
8. Net lending/borrowing	EDP B.9	-34.9	-3.8	-2.9	-2.6	-2.2	-1.9
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	23.6	2.6	2.6	2.4	2.5	2.5
pm: 9a. FISIM		-0.7	-0.1	0.0	0.0	0.0	0.0
10. Primary balance	[29]	-11.3	-1.2	-0.3	-0.2	0.3	0.6
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		181.8	19.7	21.1	22.4	22.7	22.3
11a. Taxes on production and imports	D.2	122.7	13.3	12.9	13.5	14.7	14.5
11b. Current taxes on income, wealth, etc	D.5	58.9	6.4	8.2	8.9	8.0	7.8
11c. Capital taxes	D.91	0.2	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	123.8	13.4	13.5	13.4	13.3	13.1
13. Property income	D.4	14.1	1.5	2.0	1.6	1.3	1.2
14. Other (14=15-(11+12+13))		42.1	4.6	5.4	4.7	4.2	3.9
15=6. Total revenue	TR	361.8	39.2	42.0	42.1	41.5	40.5
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[30]		302.5	32.8	35.0	36.2	36.3	35.8
Selected components of expenditure							
16. Collective consumption	P.32	76.0	8.2	8.0	7.7	7.6	7.3
17. Total social transfers	D.62 + D.63	237.4	25.7	26.1	26	25.3	24.4
17a. Social transfers in kind	P.31=D.63	89.1	9.6	10.0	9.7	9.5	9.2
17b. Social transfers other than in kind	D.62	148.3	16.1	16.1	16.3	15.8	15.2
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	23.6	2.6	2.6	2.4	2.5	2.5
19. Subsidies	D.3	4.6	0.5	1.0	1.0	0.9	0.8
20. Gross fixed capital formation	P.51	30.9	3.4	3.9	4.0	4.0	4.0
21. Other (21=22-(16+17+18+19+20))		24.2	2.6	3.3	3.6	3.4	3.4
22=7. Total expenditure	TE[31]	396.7	43	44.9	44.7	43.7	42.4
Pm: compensation of employees	D.1	93.6	10.2	10.2	10.0	9.6	9.2

[28] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[29] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
[30] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
[31] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function[32]

% of GDP	COFOG Code	**2003**	**2008**
1. General public services	1	4.7	
2. Defence	2	1.2	
3. Public order and safety	3	1.8	
4. Economic affairs	4	1.8	
5. Environmental protection	5	0.1	
6. Housing and community amenities	6	0.3	
7. Health	7	4.0	
8. Recreation, culture and religion	8	0.1	
9. Education	9	3.9	
10. Social protection	10	18.8	
11. Total expenditure (= item 7=26 in Table 2)	TE[33]	**36.7**	

Table 4. General government debt developments

% of GDP		**2004**	**2005**	**2006**	**2007**	**2008**
1. Gross debt[34]		41.9	42.5	45.0	45.3	45.4
2. Change in gross debt ratio		-2.0	0.6	2.5	0.3	0.1
Contributions to changes in gross debt						
3. Primary balance[35]		-1.2	-0.3	-0.2	0.3	0.6
4. Interest expenditure (incl. FISIM) [36]		2.6	2.6	2.4	2.5	2.5
5. Stock-flow adjustment						
of which: - Differences between cash and accruals[37]						
- Net accumulation of financial assets[38] *of which:* *- privatisation proceeds*		-0.8	-0.3	-0.4	-0.3	-0.2
- Valuation effects and other[39]		-2.2	-0.3	-0.3	-0.2	-0.2
p.m. implicit interest rate on debt[40]		6.4	6.5	6.0	5.9	5.9
Other relevant variables						
6. Liquid financial assets[41]						
7. Net financial debt (7=1-6)		45.9	47.9	51.2	52.1	52.6

32 It covers ca. 80% of the general government sector.
33 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
34 As defined in Regulation 3605/93 (not an ESA concept).
35 Cf. item 10 in Table 2.
36 Cf. item 9 in Table 2.
37 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
38 Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
39 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
40 Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
41 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	**2004**	**2005**	**2006**	**2007**	**2008**
1. Real GDP growth (%)		5.3	3.3	4.3	4.6	5.0
2. Net lending of general government	EDP B.9	-3.8	-2.9	-2.6	-2.2	-1.9
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	2.6	2.6	2.4	2.5	2.5
4. Potential GDP growth (%) (1)		3.7	4.0	4.3	4.6	4.7
contributions: - labour - capital - total factor productivity						
5. Output gap		0.4	-0.3	-0.2	-0.2	0.1
6. Cyclical budgetary component		0.1	-0.1	-0.1	-0.1	0.0
7. Cyclically-adjusted balance (2-6)		-3.9	-2.8	-2.5	-2.1	-1.9
8. Cyclically-adjusted primary balance (7-3)		-1.3	-0.2	-0.1	0.4	0.6

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	**2004**	**2005**	**2006**	**2007**	**2008**
Real GDP growth (%)						
Previous update		5.7	5.0	4.8	5.6	-
Current update		5.3	3.3	4.3	4.6	5.0
Difference		-0.4	-1.7	-0.5	-1.0	-
General government net lending (% of GDP)	EDP B.9					
Previous update		-5.4	-3.9	-3.2	-2.2	-
Current update		-3.8	-2.9	-2.6	-2.2	-1.9
Difference		1.6	1.0	0.6	0.0	-
General government gross debt (% of GDP)						
Previous update		45.9	47.6	48.0	47.3	-
Current update		41.9	42.5	45.0	45.3	45.4
Difference		-4.0	-5.1	-3.0	-2.0	-

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditures		18.6	15.2	12.8	12.5	12.4
Pension expenditure		13.7	11.3	9.8	9.5	9.3
Social security pension		13.7	11.3	9.7	9.2	8.0
Old-age and early pensions		11.1	9.4	8.4	7.9	6.6
Other pensions (disability, survivors)		2.6	1.9	1.4	1.3	1.4
Occupational pensions (if in general government)		0.0	0.0	0.0	0.0	0.0
Health care						
Long-term care *(this was earlier included in the health care)*						
Education expenditure		4.9	3.9	3.0	3.0	3.1
Other age-related expenditures		0.0	0.0	0.0	0.0	0.0
Interest expenditure		0.0	0.0	0.0	0.0	0.0
Total revenue						
Of which: property income		0.0	0.0	0.0	0.0	0.0
of which: from pensions contributions (or social contributions if appropriate)		9.2	9.6	10.1	10.1	10.2
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)		8.4 0.2	15.9 0.4	33.5 0.3	51.1 0.4	85.0 0.5
Assumptions						
Labour productivity growth		4.2	3.6	3.1	2.7	1.7
Real GDP growth		3.3	5.0	3.2	2.2	0.4
Participation rate males (aged 20-64)		77.8	79.9	82.1	84.0	81.7
Participation rates females (aged 20-64)		65.1	67.0	71.3	74.4	70.3
Total participation rates (aged 20-64)		71.4	73.4	76.7	79.2	76.1
Unemployment rate		18.2	15.8	9.9	7.0	7.0
Population aged 65+ over total population		13.1	13.5	18.2	22.6	29.4

Table 8. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate[42] (annual average)	5.8	5.3	4.5	4.5	4.5
Long-term interest rate (annual average)	6.9	5.2	5.0	5.0	5.0
USD/€exchange rate (annual average) (euro area and ERM II countries)					
Nominal effective exchange rate	0.6	-11.3	-1.5	0.5	-1.3
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	4.53	4.03	3.90	3.92	3.87
World excluding EU, GDP growth	5.9	5.1	4.9	4.6	4.6
EU GDP growth	2.4	1.5	2.1	2.4	2.4
Growth of relevant foreign markets	9.6	6.5	7.8	7.6	7.6
World import volumes, excluding EU	13.9	8.6	8.7	8.4	8.4
Oil prices, (Brent, USD/barrel)	37.8	55.0	61.4	60.3	60.3

[42] If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		X	Delay caused by the change of cabinets in November 2005 and change of ministers of finance in early January 2006
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).		X	Table 2 (general government budgetary prospects) is split into a different tables
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	Employment and labour productivity measured per hours worked have not been provided. General government expenditure by function for 2008 is missing. Differences between cash and accruals, net accumulation of financial assets are also missing. Total revenues and expenditures in Table 7 (long-term sustainability) are

Guidelines in the new code of conduct	Yes	No	Comments
			missing.
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	X		
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.			*not applicable*
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.	X		
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.		X	
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.	X		
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			*not applicable*
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			*not applicable*

Guidelines in the new code of conduct	Yes	No	Comments
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	**X**		However, less detailed, mainly concentrating on changes in the main macroeconomic assumptions
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			*not applicable*
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	**X**		
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	**X**		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	**X**		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	**X**		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	**X**		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].			**X**
– Member States should avoid pro-cyclical fiscal policies[2].			**X**
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].		**X**	
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			**X**
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			**X**
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	**X**		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		**X**	

Notes:

[1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.

[2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".

[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[43]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[44]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

[43] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[44] The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon^{'}_{T_i,B_i}\varepsilon^{'}_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon^{'}_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon^{'}_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_iB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

	2006		2007		2008	p.m.:
	COM	CP	COM[2]	CP	CP	OECD[1]
Taxes on production and imports:						
Change in tax-to-GDP ratio	0.2	0.6	-0.2	1.3	-0.2	/
Difference	0.4		1.4		/	/
of which[3]: - elasticity component	0.6		1.7		/	/
- composition component	0.1		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[4]	1.4	2.1	1.0	3.0	1.0	1.00
- of tax base[4] to GDP	0.9	0.9	0.8	0.8	0.8	1.00
Social contributions:						
Change in tax-to-GDP ratio	-0.2	-0.1	-0.5	-0.1	-0.2	/
Difference	0.1		0.4		/	/
of which[3]: - elasticity component	0.1		0.4		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	0.9	1.0	0.6	1.1	1.0	1.00
- of tax base[5] to GDP	0.9	0.9	0.8	0.8	0.8	0.70
Personal income tax[6]:						
Change in tax-to-GDP ratio	0.0	0.5	0.0	-0.6	-0.1	/
Difference	0.5		-0.6		/	/
of which[3]: - elasticity component	0.5		0.5		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	1.2	3.1	1.2	-0.9	0.8	1.40
- of tax base[5] to GDP	0.9	0.9	0.8	0.8	0.8	0.70
Corporate income tax[6]:						
Change in tax-to-GDP ratio	0.0	0.2	0.0	-0.3	-0.1	/
Difference	0.2		0.3		/	/
of which[3]: - elasticity component	0.2		0.3		/	/
- composition component	0.0		0.0		/	/
p.m.: Observed elasticity:						
- of taxes to tax base[7]	0.9	2.4	0.9	-0.6	0.6	1.00
- of tax base[7] to GDP	1.1	1.1	1.1	1.1	1.1	1.39

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	**ex-ante[1]**	**COM[2] (observed)**	**ex-ante[1]**
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.2	0.0	-0.2	0.0
Difference	0.2		-0.2	
of which[3]: - elasticity component	0.3		0.0	
- composition component	-0.2		-0.2	
p.m.: Observed elasticity:				
- of taxes to tax base[4]	1.4	1.0	1.0	1.0
- of tax base[4] to GDP	0.9	1.0	0.8	1.0
Social contributions:				
Change in tax-to-GDP ratio	-0.2	-0.2	-0.5	-0.3
Difference	0.0		-0.2	
of which[3]: - elasticity component	-0.1		-0.3	
- composition component	0.1		0.1	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	0.9	1.0	0.6	1.0
- of tax base[5] to GDP	0.9	0.7	0.8	0.7
Personal income tax[6]:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
Difference	0.0		0.0	
of which[3]: - elasticity component	-0.1		0.0	
- composition component	0.1		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	1.2	1.4	1.2	1.4
- of tax base[5] to GDP	0.9	0.7	0.8	0.7
Corporate income tax[6]:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.1
Difference	0.0		-0.1	
of which[3]: - elasticity component	0.0		0.0	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[7]	0.9	1.0	0.9	1.0
- of tax base[7] to GDP	1.1	1.4	1.1	1.4

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	**3.6**	**3.6**	**3.1**	**3.1**	**2.7**	**2.7**	**1.7**	**1.7**
Real GDP growth	**5.0**	**5.0**	**3.2**	**3.2**	**2.2**	**2.2**	**0.4**	**0.4**
Participation rate males (aged 20-64)	**79.9**	**79.9**	**82.1**	**82.1**	**84.0**	**84.0**	**81.7**	**81.7**
Participation rates females (aged 20-64)	**67.0**	**67.0**	**71.3**	**71.3**	**74.4**	**74.4**	**70.3**	**70.3**
Total participation rates (aged 20-64)	**73.4**	**73.4**	**76.7**	**76.7**	**79.2**	**79.2**	**76.1**	**76.1**
Unemployment rate	**15.8**	**15.8**	**9.9**	**9.9**	**7.0**	**7.0**	**7.0**	**7.0**
Population aged 65+ over total population	**13.5**	**13.5**	**18.2**	**18.2**	**22.6**	**22.6**	**29.4**	**29.4**

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	16.6	15.2	12.7	12.2	11.7	11.1	-5.5	-4.6
Pensions	12.3	11.3	9.7	9.2	8.6	8.0	-4.3	-3.4
Health care	-	-	-	-	-	-	-	-
Long-term care	-	-	-	-	-	-	-	-
Education	4.3	3.9	3.0	3.0	3.1	3.1	-1.2	-1.2
Unemployment benefits	-	-	-	-	-	-	-	-
Total primary non age-related spending	23.3	23.3	23.3	23.3	23.3	23.3	0.0	0.0
Adjusted total revenues	38.5	38.5	38.5	38.5	38.5	38.5	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

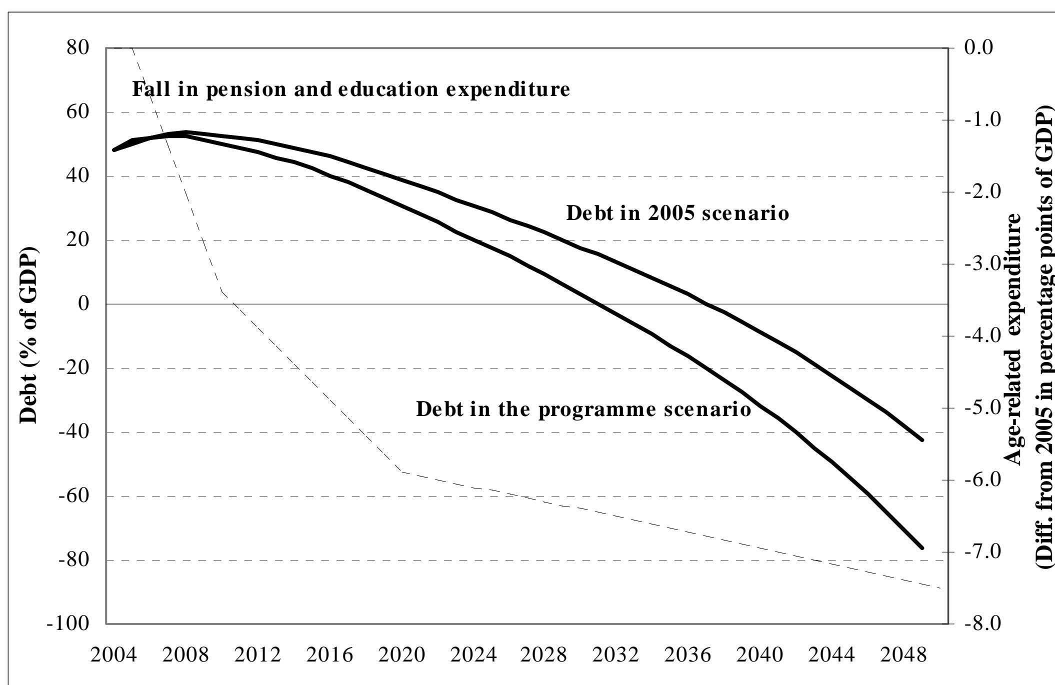
	S1	S2
2005 scenario	**-0.3**	**-0.1**
Programme scenario	**-0.3**	**-0.2**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	52.6	51.3	33.2	6.2	-27.7	-76.3	-128.9
*Gross debt, i + 1*****	*52.6*	*52.3*	*38.4*	*14.3*	*-18.5*	*-69.1*	*-121.7*
*Gross debt, i - 1*****	*52.6*	*50.3*	*28.5*	*-0.1*	*-33.4*	*-77.8*	*-130.4*
2005 Scenario							
Gross debt	53.3	53.2	40.6	20.0	-5.7	-42.5	-95.8
*Gross debt, i + 1*****	*53.3*	*54.2*	*46.3*	*29.6*	*7.3*	*-27.3*	*-80.6*
*Gross debt, i - 1*****	*53.3*	*52.2*	*35.6*	*12.4*	*-14.4*	*-50.2*	*-103.5*

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.



Box: Eurostat's decision concerning funded defined-contribution pension schemes

A number of Member States have switched a part of their social security pension schemes into funded schemes. According to the decision of Eurostat (2 March 2004) those schemes should be recorded in the private sector in the national accounts. The rationale underlying the decision is that these schemes, even when run by government, should be considered as owned by the pension beneficiaries, who are the ultimate economic owners, i.e., those bearing most of the risk, associated mainly with financial market developments. Member States are required to implement the Eurostat decision, by classifying funded, defined-contribution schemes outside the government sector, by March 2007 at the latest.

The reclassification of the funded defined-contribution pension schemes may significantly change short term general government revenue and therefore decrease the current general government balance, while changes in expenditure will only materialize in the long term. Therefore, such a reform would improve long-term government balances but would increase the short-term deficit. Reducing both current revenue and long-term expenditure should be, neutral or positive in terms of long-term sustainability and, theoretically, S2 should remain stable or decrease if revenue and expenditure were available in the very long-run. It might be the case that the new system has not reached its steady state in 2050 (i.e. the private pension/GDP ratio may still be increasing after 2050), which would imply that the calculated S2 may overestimate the risk to long-term sustainability.

Long-term pension projections included in the Poland's convergence programme cover public pension schemes, excluding private pension schemes. The current budgetary position should therefore be corrected for short-term reduction of the corresponding revenue (which amounts to 1.7% of GDP in 2005, 2% of GDP in 2007 and 1.5% of GDP in 2007 and 1.8% of GDP in 2008 according to the updated convergence programme).